

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **201105001**

Release Date: 2/4/2011

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Index Number: 7702B.02-00

Telephone Number:

Refer Reply To:

CC:FIP:B04

PLR-100719-10

Date:

October 22, 2010

Legend

Taxpayer:

Annuity Contract 1:

Annuity Contract 2:

Rider:

Dear :

This is in response to your request for a ruling that a rider to be offered with certain annuity contracts constitutes an “insurance contract” for purposes of § 7702B(b)(1) of the Internal Revenue Code.

FACTS

Taxpayer represents as follows:

Taxpayer is a stock life insurance company taxable under § 801 and is the issuer of certain annuity contracts, among which are Annuity Contract 1, a single premium deferred fixed annuity contract, and Annuity Contract 2, a flexible premium deferred variable annuity contract. Taxpayer proposes to offer a rider option (“Rider”) for these contracts to provide certain long-term care benefits during the time the person covered (“Specified Person”) by the Rider is a chronically ill individual with the meaning of § 7702B(c)(2)¹ and receiving qualified long-term care services within the meaning of

¹ The owner and the annuitant of the contract, and the person covered by the Rider, must be the same individual.

§ 7702B(c)(1) through the agency or facility identified in the plan of care. One version of the Rider is available in connection with Annuity Contract 1 and two versions are available in connection with Annuity Contract 2. All three versions have the same basic operation.

To be eligible for benefits under the Rider, the Specified Person must be between the ages of 35 and 79 on the date the Rider is issued and not have certain medical conditions or meet other specified disqualifying criteria. Moreover, benefits are payable only during the time the Specified Person is chronically ill as defined by § 7702B(c)(2) and only consistent with a 'grade-in' schedule. Under the grade-in schedule, benefits are not payable in any amount until the expiration of an initial period of a specified duration. After this initial period, benefits are only partially available until the expiration of a specified interim period. Moreover, benefits are not payable until a 'deductible' amount is paid on behalf of the Specified Person.

Once benefits become payable, they are paid monthly in two phases which occur prior to the annuitization of the contract: Phase I and Phase II. Together, the phases are expected to last at least 72 months; that is, the Specified Person can expect payments for at least 6 years. Phase I will have a nominal duration of either 24 or 36 months (elected by the Specified Person at issuance) and Phase II will have a nominal duration of either 48 or 36 months (as necessary to total 72 months).

There are two components to the monthly benefit amount: 'equal payments' ("Equal Payments") and 'augmented payments' ("Augmented Payments"). The monthly Equal Payments are guaranteed amounts specified in the Rider that do not fluctuate based on the cash value of the contracts. The monthly Augmented Payments are payable to the extent that certain increases in the cash value of the contract occur after the Rider is issued. They are available under the Rider connected to Annuity Contract 1 but only one of the two versions connected to Annuity Contract 2.

With respect to the Rider attached to Annuity Contract 1, the Rider must be added to Annuity Contract 1 upon the issuance of Annuity Contract 1; it cannot be added to an in-force contract. The following discussion addresses the operation of the Rider attached to Annuity Contract 1.

The amount of each monthly Equal Payment payable during Phase I is determined by dividing the Phase I Equal Payment Limit by the length of Phase I (either 24 or 36 months). The Phase I Equal Payment Limit is initially set as the cash value of Annuity Contract 1 at issue. The amount of the monthly Equal Payment, and the Phase I Equal Payment Limit, are reduced, proportionally, by any withdrawals from Annuity Contract 1. If any benefits are paid during the interim period of the grade-in schedule, the balance of the months remaining in the interim period is added to the length of Phase I.

The amount of monthly benefits may not be the full amount of the monthly Equal Payment. If the Specified Person is receiving neither nursing home nor hospice care, as defined in the Rider, the amount of the monthly Equal Payment actually paid will be no more than 50% of the Equal Payment ("Half Equal Payment").

In addition to the Equal Payment or Half Equal Payment, the Rider provides for Augmented Payments if the cash value of Annuity Contract 1 exceeds the Phase I Equal Payment Limit. The Augmented Payments operate similarly to the Equal Payments. There is an Augmented Payment Limit, which is the excess of the cash value of Annuity Contract 1 over the Phase I Equal Payment limit as of the Rider anniversary. This Augmented Payment Limit is then divided by the sum of the remaining months in Phase I and Phase II to arrive at the full amount of the monthly Augmented Payment. If the Specified Person is receiving neither nursing home nor hospice care, as defined in the Rider, the amount of monthly Augmented Payment actually paid will be no more than 50% of the Augmented Payment ("Half Augmented Payment"). The Augmented Payment, or Half Augmented Payment, is received only if the complete underlying Equal Payment or Half Equal Payment is received. Any withdrawals from Annuity Contract 1 will reduce proportionally the amounts of the Augmented Payment and Augmented Payment Limit.

During Phase I, the receipt of monthly Equal Payments or Half Equal Payments reduces the cash value of Annuity Contract 1 'dollar for dollar'. Phase I ends once the aggregate of monthly Equal Payments or Half Equal Payments equals the Phase I Equal Payment Limit. If at that point the Specified Person is chronically ill, Phase II begins.

In Phase II, the monthly Equal Payments or Half Equal Payments, as appropriate, continue. Unlike during Phase I, the Phase II monthly Equal Payments or Half Equal Payments will not reduce the cash value of Annuity Contract 1. Thus, Phase II monthly Equal Payments or Half Equal Payments will be comprised entirely of 'net amount at risk' that Taxpayer pays from a reserve or its own surplus.

As described above, Phase II will have a nominal duration of either 24 or 36 months, depending on the nominal duration of Phase I. If the nominal duration of Phase II is 36 months (i.e., both Phase I and Phase II have the same length), the Phase II Equal Pay Limit is the same as that of Phase I. If the nominal duration of Phase II is 48 months (i.e., twice that of Phase I), the Phase II Equal Pay Limit is twice that of Phase I. During Phase II, the monthly Equal Payments or Half Equal Payments will continue until the aggregate of the monthly Equal Payments or Half Equal Payments equals the Phase II Equal Pay Limit. The monthly Equal Payment amount, and the Phase II Equal Pay Limit, are reduced proportionally by any withdrawals from Annuity Contract 1 during Phase II.

Any monthly Augmented Payments or Half Augmented Payments made during

Phase II will reduce the cash value of Annuity Contract 1; the amount of any such payments are reduced proportionally by a withdrawal from Annuity Contract 1.

To the extent the payment of benefits has not exhausted the cash value of Annuity Contract 1, the excess cash value will be applied to the benefits nominally provided by Annuity Contract 1.

If, upon the maturity date of Annuity Contract 1, the Specified Person is receiving Rider benefits, the benefits will continue to be paid as described above. Upon the Specified Person's recovery from the chronic illness, or upon the expiration of Phase II, an annuity payout option must be chosen within 90 days.

If, upon the maturity date of Annuity Contract 1, the Specified Person is not receiving Rider benefits, unless otherwise agreed by Taxpayer, the Rider Charges (discussed next) will cease, the Phase I Equal Payment Limit and the Augmented Payment Limit will be reduced to zero, and any remaining Phase II Equal Payment Limit will continue as paid-up long-term care insurance coverage. If the Specified Person subsequently becomes eligible for Rider benefits, the monthly Equal Payment or Half Equal Payments, as appropriate, will be made until the aggregate of such payments equals the Phase II Equal Payment Limit or the Specified Person is no longer chronically ill.²

The Rider is funded by periodic charges ("Rider Charge") deducted from the cash value of Annuity Contract 1, and is, subject to change by Taxpayer, comprised of a percentage of the Phase I Equal Payment Limit and the Phase II Equal Payment Limit.³

Finally, the Rider provides nonforfeiture benefits. If Taxpayer increases⁴ the element of the Rider Charge allocable to the Phase II Equal Payment Limit and in response thereto Annuity Contract 1 is surrendered, the Specified Person will be entitled to a benefit in the event of subsequent chronic illness. This benefit will be an amount that is the greater of a single monthly Equal Payment and the sum of the paid Rider Charges applicable to Phase II, less any Phase II benefits previously received. Alternatively, for an additional charge, a nonforfeiture benefit will be paid if Annuity

² Because these are treated as Phase II payments, they do not reduce the cash value of Annuity Contract 1.

³ The amount of the charge is determined through utilization of actuarial techniques to arrive at a charge that provides a pool of premiums to pay covered claims and a profit for the issuer.

⁴ Such increase can be on only a nondiscriminatory class basis with approval of the appropriate state regulator(s).

Contract 1 is surrendered or an annuity payout option is elected before the maturity date. This alternative nonforfeiture benefit is the greater of a single monthly Equal Payment and the sum of the paid Rider Charges applicable to Phase II and the additional nonforfeiture charge, less any Phase II benefits previously received.

When the Rider is attached to Annuity Contract 2,⁵ certain Rider functions are different because that contract is a variable contract. For one thing, there are two variations of the Rider: a “Level Variable Rider” and a “Growth Variable Rider”. By analogy to the Rider available in connection with Annuity Contract 1, the Level Variable Rider provides only Equal Payments while the Growth Variable Rider provides both Equal and Augmented Payments.

With respect to the payment limits, when a Rider is added to an in-force Annuity Contract 2 the limit will be determined on the Rider issue date by reference to the contract’s cash value; when a Rider is included at issuance of Annuity Contract 2 the limit will be determined on a specified subsequent date by reference to all allowed premiums paid as of that date. The Annuity Contract 2 Riders require the selection of a “Payment Limit Percentage”; accordingly, the Phase I Equal Payment Limit will be some percentage of the premiums paid, rather than equal to the value as is the case with Annuity Contract 1.

The Augmented Payments provided by the Growth Variable Rider are determined differently than in connection with Annuity Contract 1. On each Rider anniversary, the current cash value is multiplied by the Payment Limit Percentage to produce a “Gross Benefit Excess.” The Gross Benefit Excess is compared to the Phase I Equal Payment Limit; to the extent the Gross Benefit Excess is larger, the difference is the “Net Benefit Excess” which is available to fund Augmented Payments. This process continues until a time specified in the Growth Variable Rider.⁶ Accordingly, the total of the amount of Rider benefits funded from the value of Annuity Contract 2 is the Phase I Equal Payment Limit plus the Net Benefit Excess (“Total Cash Value Benefits”).

The amount of monthly Augmented Payments provided under the Growth Variable Rider is determined by dividing the Net Benefit Excess by the number of months remaining in Phase I plus Phase II.

The mechanism to pay Rider benefits under Annuity Contract 2 is different than that for Annuity Contract 1. When benefits are approved, the amount of the Total Cash

⁵ The Rider can be added to an in-force Annuity Contract 2.

⁶ The annual determinations stop once the Specified Person attains age 85, or after a specified number of years, or once a specified maximum value is reached. Annual determinations can be foregone after a specified number of years.

Value Benefits is transferred from Taxpayer's segregated asset account(s) to its general account,⁷ and treated accordingly.⁸ To the extent the balance of the amount transferred to the general account becomes less than the balance of the Total Cash Value Benefits,⁹ the shortfall will be cured by transferring additional amounts from the segregated asset account(s) to the general account. If the payment of Rider benefits exhausts the cash value before benefits equaling the Total Cash Value Benefits have been paid, the balance of the Total Cash Value Benefits, plus all Phase II Equal Payments, will be paid out of Taxpayer's reserves or surplus. Conversely, if the balance of the amount transferred to the general account exceeds the balance of the Total Cash Value Benefits, the excess will be returned to the segregated asset account(s), and allocated consistent with the terms of Annuity Contract 2.

Taxpayer anticipates issuing the Rider to a large number of Specified Persons.

REQUESTED RULING

Taxpayer requests a ruling that the Rider constitutes an insurance contract for purposes of § 7702B(b)(1).

LAW AND ANALYSIS

Section 7702B(b)(1) provides that a qualified long-term care insurance contract is "any insurance contract" that has certain attributes.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The Supreme Court of the United States has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531 (1941). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 2007-47, 2007-2 C.B. 127. In addition, the arrangement must constitute insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1153 (Fed. Cir. 1993); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992), aff'd 96 T.C. 18 (1991).

⁷ If the cash value is less than the Total Cash Value Benefits, the entire cash value will be transferred.

⁸ Interest will be credited at no less than a specified minimum rate.

⁹ If, for example, Rider Charges are greater than current interest credits.

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

The “commonly accepted sense” of insurance derives from all the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with those arrangements known to constitute insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of the arrangement under the applicable state law, AMERCO v. Commissioner, 96 T.C. at 41; the adequacy of the insurer’s capitalization and utilization of premiums priced at arm’s length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff’d 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling, 988 F.2d at 1151; and the language of the operative agreements and the methods of resolving claims, Kidde Indus. Inc. v. United States, 40 Fed. Cl. 42, 51-53 (1997).

Addressing whether bail bonds constituted insurance, the court in Allied Fidelity Corp. described insurance as

an agreement to protect the insured against a direct or indirect economic loss arising from a defined contingency whereby the insurer undertakes no present duty of performance but stands ready to assume the financial burden of any covered loss. ... [A]n insurance contract contemplates a specified insurable hazard or risk with one party willing, in exchange for the payment of premiums, to agree to sustain economic loss resulting from the occurrence of the risk specified and, another party with an ‘insurable interest’ in the insurable risk. It is important here to note that one of the essential features of insurance is this assumption of another’s risk of economic loss.

Allied Fidelity Corp., 572 F.2d at 1193 (citations omitted).

The risk of incurring expenses related to long-term care services is a morbidity risk. A morbidity risk is an insurance risk. See, Haynes v. United States, 353 U.S. 81, 83 (1957) (“Broadly speaking, health insurance is an undertaking by one person for

reasons satisfactory to him to indemnify another for losses caused by illness.”); cf. Rev. Rul. 68-27, 1968-1 C.B. 315 (medical services for illness or disability provided by staff-model medical clinic for fixed monthly fee involve a normal business risk of an organization engaged in furnishing medical services on a fixed-price basis, rather than an insurance risk).

The crux of the issue is whether there is a possibility that any particular insured could incur a loss reimbursable by the Rider. If there were never any reasonable possibility, the Rider would fail to constitute insurance. For example, if the Rider were structured such that the long-term care benefits were funded entirely by the accumulated value of the annuity contract, there would be no risk shifted to Taxpayer.

Here, the Specified Person has a risk of economic loss if that person suffers prolonged morbidity, i.e., becomes chronically ill. Through the Rider, in consideration for the Rider Charge, Taxpayer assumes the risk that the Specified Person will be eligible for long-term care benefits in excess of the Phase I Equal Payment Limit. The risk assumed by Taxpayer will be distributed across the large number of other Specified Persons who purchase the Rider. The Rider conforms to insurance in the commonly accepted sense. Accordingly, the Rider constitutes an insurance contract for purposes of § 7702B(b).

RULING

The Rider constitutes an insurance contract for purposes of § 7702B(b)(1).

CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. No ruling has been requested, and no opinion is expressed, concerning whether the Rider constitutes a qualified long-term care insurance contract; the treatment of any distributions from Annuity Contract 1, Annuity Contract 2, or the Rider; or the treatment of the payment of the Rider Charges.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this letter ruling have not yet been adopted. Therefore, this letter ruling will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the letter ruling. See § 11.04, Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 49. If the taxpayer can demonstrate that the criteria in § 11.06 of Rev. Proc. 2010-1 are satisfied, a letter ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/S/

SHERYL B. FLUM
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)